In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 910

SOUTH TEXAS RICE WAREHOUSE CO., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

This case involves the scope of the Commissioner's power under § 482 of the Internal Revenue Code of 1954 (App. *infra*, p. 9) to allocate income and deductions among commonly controlled organizations in order to prevent the avoidance of taxes or clearly to reflect their income.

Petitioner's principal business consisted of drying, cleaning and warehousing rice. Its stock was owned by four families, each owning a one-fourth interest. During June, 1957, various members of the four families formed a partnership (with each family owning a 25 percent interest). Petitioner then leased its operating assets—which were worth at least

$700,000—to the partnership for an annual rental of $48,000. (Pet. 28–30, 36.)

For the three fiscal years preceeding this lease to the partnership (1955–1957), petitioner had net earnings of $130,000, $171,000 and $75,000, respectively. For the three fiscal years following the lease (1958–1960), petitioner suffered net losses of $33,000, $18,000, and $12,000, *i.e.*, its deductions for depreciation, taxes, etc. exceeded its $48,000 annual rental income by these amounts. During these same three years the partnerships' net income from operating the leased properties was $127,000, $75,000, and $109,000. (Pet. 37.)

Petitioner sought to carry its 1958–1960 net losses back to previous years and filed a claim for refund of taxes paid in earlier years. The Commissioner, exercising his authority under § 482, determined, *inter alia*, that the rental paid by the partnership to petitioner was inadequate; that the rent was not negotiated in an arm's length transaction; and that sufficient partnership income should be allocated to petitioner to provide a reasonable rental of $78,000 per year. (R. 227.) [1] Both the Tax Court and the court of appeals upheld the Commissioner's determination. (R. 229–241; Pet. 32–41.)

The decision below is correct, turns on the particular facts of this case, and presents no conflict or other reason warranting further review by this Court.

1. The purpose of § 482 (first appearing in its present form in the Revenue Act of 1928, c. 852, 45 Stat.

[1] "R." references are to the printed record in the court of appeals.

791) is to prevent a taxpayer from arbitrarily shifting part of its income or deductions to a related taxable entity, and thereby distorting its true taxable income. The Commissioner's reallocation authority under § 482 extends to any case in which, either by inadvertence or design, the taxable net income is different than it would have been had the commonly controlled entities dealt with each other at arm's length. See Treas. Reg., § 1.482–1(b) (App., *infra*, pp. 10–12); *Commissioner* v. *Chelsea Products*, 197 F. 2d 620 (C.A. 3); *Grenada Industries, Inc.* v. *Commissioner*, 17 T.C. 231, affirmed, 202 F. 2d 873 (C.A. 5), certiorari denied, 346 U.S. 819; *Aiken Drive-In Theatre Corp.* v. *United States*, 281 F. 2d 7 (C.A. 4); *Spicer Theatre, Inc.* v. *Commissioner*, 346 F. 2d 704 (C.A. 6); *Oil Base, Inc.* v. *Commissioner*, 362 F. 2d 212 (C.A. 9), certiorari denied, 385 U.S. 928.

Whether the Commissioner, under § 482, properly allocated income from the partnership to petitioner, is, as the court below recognized (Pet. 41), essentially a question of fact.[2] The Tax Court analyzed the facts in great detail and concluded that the Commissioner did not abuse his discretion in allocating additional income from the partnership to petitioner in order

[2] See *Asiatic Petroleum Co.* v. *Commissioner*, 79 F. 2d 234 (C.A. 2), certiorari denied, 296 U.S. 645, rehearing denied, 296 U.S. 664; *National Securities Corp.* v. *Commissioner*, 137 F. 2d 600 (C.A. 3), certiorari denied, 320 U.S. 794; *Advance Machinery Exch.* v. *Commissioner*, 196 F. 2d 1006 (C.A. 2), certiorari denied, 344 U.S. 835; *Grenada Industries, Inc.* v. *Commissioner*, *supra*; *Ballentine Motor Co.* v. *Commissioner*, 321 F. 2d 796 (C.A. 4); *Spicer Theatre, Inc.* v. *Commissioner*, *supra*; *Oil Base, Inc.* v. *Commissioner*, *supra*.

clearly to reflect income (R. 231–241). Despite petitioner's contentions (Pet. 11–15, 19–24), this factual conclusion is amply supported by the record and was correctly sustained by the court of appeals. This concurrent finding of both courts below should not be disturbed except upon an extraordinary showing of error (*Corn Products Co.* v. *Commissioner,* 350 U.S. 46; *Comstock* v. *Group of Investors,* 335 U.S. 211), and no such showing is made here.

2. In summary, the evidence shows the following: Virtually all of petitioner's operating assets—which had been producing an average net profit of $122,000 per year for the previous three years—were leased to the partnership for a gross rental of $48,000 per year. This caused petitioner to operate at an average net loss of $21,000 per year for the three years after the lease, while the partnership had average net profits of $104,000 per year (Pet. 37).

The same four families owned and controlled both petitioner and the partnership. The principal difference in ownership was that the senior members of the two families—L. D. Clements and S. M. Clements—who owned 20 percent and 15 percent, respectively, of petitioner's stock, had no ownership interest in the partnership, the partnership interests to which they were entitled being owned by their children (Pet. 29–30). As the court of appeals observed (Pet. 30, fn. 8):

> The partnership was formed for the purpose of letting the Clements families' children receive a larger part of the income generated by the rice drying and storage business.

Thus each of the four families owned 25 percent of the partnership and 25 percent of petitioner, although the ownership of stock within each family varied somewhat.[3]

The Tax Court found that the negotiations which led to the $48,000 annual rental were not at arm's length (R. 237) and that a reasonable rental for petitioner's operating assets—which were worth at least $700,000—would be $78,000 per year (R. 241). The court of appeals affirmed, observing that "The conclusion is inescapable, that if [the partnership's] income were not going to family members the lease would not have been consummated, *i.e.*, no independent party could have negotiated such a lease in an arms-length transaction" (Pet. 38–39).

3 (a). Petitioner's principal argument (Pet. 15–26) is that the Tax Court erred as a matter of law in failing to accept the testimony of its witnesses that a fair rental was not in excess of $48,000. The Tax Court was not obliged, however, to accept at face value the opinion testimony of those witnesses, not even that of the expert. The Tax Court may and

[3] Petitioner nevertheless argues briefly (Pet. 12–13) that because the two senior Clements did not personally have an ownership interest in the partnership, the two entities were not "owned or controlled directly or indirectly by the same interests." Code § 482 (App., *infra*, p. 9). The statute is broadly drafted, however, to include related entities which are "controlled," even "indirectly," by "the same *interests*" (italics added). Thus the section does not require that the same *people* own the two entities. In any event, there is no conflict of decisions on this point and petitioner does not even mention it as one of the "Reasons For Granting the Writ" (Pet. 15–24).

should exercise its own judgment on the basis of all the evidence before it. See *Sartor* v. *Arkansas Gas Corp.*, 321 U.S. 620, 627–628; *Dayton P. & L. Co.* v. *Commission*, 292 U.S. 290, 299; *Burford-Toothaker Tractor Co.* v. *Commissioner*, 192 F. 2d 633, 635 (C.A. 5), certiorari denied, 343 U.S. 941; *Penn* v. *Commissioner*, 219 F. 2d 18, 21 (C.A. 9); *Kreis' Estate* v. *Commissioner*, 227 F. 2d 753, 755 (C.A. 6). As the court below pointed out (Pet. 40), petitioner's witnesses failed to take certain significant factors into account in forming their opinions. Moreover, petitioner ignores much of the evidence considered by the Tax Court and makes no attempt to explain why a corporation that had average net profits of $122,000 for the past three years and had just completed a new storage facility at a cost of $165,000 would agree to lease all of its facilities for only $48,000 a year if it had been an independent party negotiating a fair rental.

(b) Petitioner asserts (Pet. 6, 16–20) that the decision below is in conflict with decisions like *Robinson Truck Lines, Inc.* v. *Commissioner*, 183 F. 2d 739 (C.A. 5); *J. M. Perry & Co.* v. *Commissioner*, 120 F. 2d 123 (C.A. 9); *Anaheim Union Water Co.* v. *Commissioner*, 321 F. 2d 253 (C.A. 9). In those cases the taxpayers supported their positions by disinterested and uncontradicted testimony credible in itself and not impeached in any way, whereas in the instant case there was ample evidence contradicting the testimony of petitioner's witnesses and supporting the finding of the Tax Court. Moreover, none of the cases cited by

petitioner dealt with the Commissioner's power under Code § 482 to allocate income and deductions between commonly controlled organizations in order to prevent the avoidance of taxes or clearly to reflect their income.

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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